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SUBJECT: NEPAL: THE COST OF THE MAOIST INSURGENCY

Summary

11. (U) The seven-year Maoist insurgency in Nepal has taken a tremendous toll on the already impoverished Nepalese economy. The impact of the conflict is obvious in the floundering tourist sector, the depressed foreign investment climate, stalled economic development projects, crippled infrastructure, and the sharp increase in security spending. Various studies indicate that the loss to Gross Domestic Product (GDP) over the seven-year period is in the range of USD 740 million to USD 1 billion. The cost to reconstruct public and private infrastructure destroyed by the Maoists will amount to around USD 54 million. On the foreign investment front, reports from Nepal's Department of Industries paint a bleak picture for foreign direct investment, which declined by over 47 percent in the first quarter of the Nepalese fiscal year 2003/04. END SUMMARY.

Loss in Gross Domestic Product

12. (U) The seven-year Maoist insurgency has taken a tremendous toll on Nepal's economy. Various studies indicate that the loss to Gross Domestic Product (GDP) over the seven-year period is in the range of USD 740 million to USD 1 billion. For the first time in nineteen years, during the year 2001/02, real GDP registered negative growth (-0.46% according to revised GON figures) due mostly to the increase of Maoist violence, destruction of infrastructure, losses due to strikes, and decrease in investor and consumer confidence domestically.

13. (U) Although government revenues (estimated at USD 729.1 million) increased 12 percent in 2002/03, the GON has outstripped this growth in revenues with increased spending (total GON expenditures amount to USD 934 million). For example, during this timeframe, security spending (including military, police and armed police expenditures) amounted to USD 182 million (or 25 percent of government revenues). Total development spending (including items like education, health, construction projects) equaled USD 370 million (or 50.7 percent of government revenues), and other government spending (administrative, salaries, etc.) totaled USD 564.2 million.

A Challenging Investment Climate

14. (U) Insecurity, uncertainty, and forced Maoist extortions, coupled with inadequate government security and poor infrastructure, create a challenging investment climate in Nepal. In October 2003, the Department of Industry (DoI) reported a decrease in foreign direct investment (FDI) of over 47 percent, during the first quarter of the Nepalese fiscal year (which began in July) totaling NRs. 383.38 million (USD 5.1 million). The same period the previous year recorded FDI of NRs. 733.79 million (USD 9.1 million).

15. (U) During the early years of Nepal's new democracy in the 1990s, there was a sharp increase in FDI as a result of economic liberalization and stabilization under the G.P. Koirala administration in part spurred by USAID programs. FDI for 1992/93 totaled a staggering, for Nepal, USD 365 million. The G.P. Koirala administration pursued privatization, opened certain sectors to foreign investment, and reduced regulatory and financial barriers. The following year, however, a change in government, corruption allegations, and a decrease in investor confidence resulted in a decline of 79 percent in FDI (to about USD 76 million). Foreign investment experienced a slight increase (to about USD 179 million) again under the Sher Bahadur Deuba administration, but investment in Nepal has yet to reach the levels experienced during 1992/93.

16. (U) The recent problems of foreign investment were exemplified in the German-supported hydropower joint venture

known as the Middle Marsyangdi Hydroelectric Project. Recently, the 70-megawatt power project was terminated, citing security concerns around the project site and a contract dispute with the Nepal Electricity Authority (NEA) over 48 million Euros overdue to the German investor. (Note: News reports indicate that work on the project was halted on 10 October after the Maoists ambushed a project vehicle and killed two workers. End Note.) The termination of this project amounts to a loss of about USD 190 million. (Comment: The Bhote Koshi hydroelectric power plant (an American investment) has also had contractual and payment problems with NEA. Given the history of the NEA at times skating around the sanctity of contracts, in addition to increased security concerns, it is unlikely that there will be a significant increase in hydropower sector from foreign investment in the near future. End Comment.)

Imbalance in Security Versus Development Expenditures

17. (U) According to GON figures, security spending in 1997/98 amounted to USD 75 million (or 9 percent of the GON budget) whereas the estimated expenditure for 2002/03 amounted to USD 182 million (or 16.3 percent of the GON budget). This increase has had serious implications for the on GON's development spending, which during the same timeframe actually declined by 18.5 percent. Development spending for 1997/98 amounted to USD 428 million or about 52 percent of the budget, whereas spending in 2002/03 amounted to USD 369.7 million or 33 percent of the budget.

18. (U) The GON currently has earmarked NRs. 14.74 billion (equivalent to USD 199 million) for security purposes. Recent news reports refer to a supplemental budget request of NRs 1.8 billion (equivalent to about USD 24 million) from the Defense Ministry. The additional moneys were requested to improve troop mobilization and surveillance/intelligence capabilities. During a meeting with international donors in September 2003, Minister of Finance Dr. Prakash Chandra Lohani indicated that the GON might reallocate the NRs. 1.7 billion (equivalent to USD 22.9 million) earmarked for the election fund to address pressing security needs. (Comment: Although a large portion of Nepal's security spending is directly related to the insurgency, it is not accurate to attribute the entire increase in security expenditures to this purpose. Since Nepal is a major and welcomed contributor to UN Peacekeeping Missions, recent UN deployments to Liberia, etc. should be taken into account. In addition, replacement of military hardware as a result of normal wear and tear should also be figured into this equation. End Comment.)

19. (U) That said, international aid commitments declined by more than 50 percent during the first 11 months of 2003, according to figures compiled by the Foreign Aid Coordination Division at the Ministry of Finance. The commitments made by bilateral and multilateral aid agencies amounted to NRs. 5.57 billion (equivalent to USD 77 million) in comparison to over NRs. 12 billion (equivalent to USD 162 million) for the same period last year. (Note: These GON numbers on foreign aid do not capture all foreign aid flows. The Ministry of Finance only keeps track of the aid that flows to and through the Ministry--it does not track aid provided to individual NGO and INGO groups in Nepal. End Note.) Nepal is highly dependent on foreign assistance for its development investment and the decrease in aid commitments comes at a critical juncture in Nepal's development history. The decrease in aid commitments is coupled with an increase of international donors' criticism of human rights violations and political uncertainty. When Post requested data on the absorption rate of international donor moneys, government sources within the Central Bureau of Statistics and the Ministry of Finance indicated that the information was "not available."

10. (U) Despite the stark contrast between security and development expenditures, development spending is projected to increase by nearly 53 percent under the GON's Tenth Plan. In the past four months alone, development spending rose by 22 percent, in part due to recently approved World Bank concessional loans of USD 70 million under its Poverty Reduction Support Credit program.

11. (U) As a result of pressures from bilateral donors, the World Bank, the Asian Development Bank and International Monetary Fund, there appears to be a new focus on development sectors like health, education, rural drinking water and local infrastructure. Nepalese planners understand that unless they increase development spending they risk losing support from the international donor community. For example, recent news reports claim that the Danish and German donors might be considering reducing or pulling development funds out of Nepal as a result of growing dissatisfaction with the insurgency, lack of governance and human rights abuses. The Dutch government is considering cutting assistance to a number of countries, a list that apparently would include

Nepal.

Destruction of Infrastructure

¶12. (U) Although it is difficult to determine the exact cost of the destruction of physical private and public infrastructure as a result of the insurgency, the generally accepted figure falls in the range of NRs. 18 to 26 billion (equivalent USD 243 million to 356 million). (Comment: Record keeping is poor, and the definition of "destruction" varies widely. In some cases, infrastructure may have been merely damaged, rather than destroyed, and remains more or less functional. Nonetheless, for a country on the edge like Nepal which has huge unmet infrastructure needs, any damage to infrastructure is disturbing. End Comment.)

¶13. (U) Data from a variety of sources indicate that, on a sectoral basis, the destruction to property amounts to:
-- Telecommunication Facilities: USD 9.46 million;
-- Electricity Plants and Facilities: USD 3.87 million;
-- Village Development Committee (local government) Offices: USD 5 million;
-- Radio Transmission Stations: USD 81 thousand;
-- Airports: USD 4 million;
-- Roads, Bridges, infrastructure-related offices: USD 62 thousand; and,
-- Banks (includes property loss and cash looted by Maoists): USD 7.6 million.

Cost of Reconstruction

¶14. (U) The National Planning Commission released a report in July 2003 that indicates the cost of reconstruction amounts to about USD 54 million. The report break downs the estimate for rebuilding infrastructure as follows:

-- Local government buildings: USD 3.5 million;
-- Infrastructure associated with the ministries of tourism, water resources, communication and physical planning: USD 22.9 million;
-- Electricity Sector: USD 4.7 to 5.4 million;
-- Communications Sector: USD 5.4 to 6 million;
-- Airport Reconstruction: USD 3.3 to 4 million;
-- Road and bridge reconstruction: USD 5.4 million;
-- Agriculture Sector: USD 2.7 million; and,
-- Educational-related property: USD 1.3 million.

Case Study: Tourism

¶15. (U) Several incidents over the past four years have caused a decline in the travel and tourist industry including the 1999 Indian Airlines hijacking, the 2001 royal family massacre, the 2001 September 11 attacks on the World Trade Center, 2002/03 Severe Acute Respiratory Syndrome (SARS), and escalation in Maoist violence coupled with general political instability in the country. According to a 2002 World Bank study, the travel and tour industry contributes about 10 percent to Nepal's GDP. Earnings in the industry declined by 50 percent in 2001 from the previous year. News reports allege that the loss to the sector in 2001 and 2002 totaled over USD 81 million. Narendra Bajracharya, President of the Hotel Association of Nepal, states that hotel occupancy rates have declined by 25 to 35 percent since 2001, this has had a crippling effect on the industry. When asked about hotel closures as a result of the decline in occupancy rates, Bajracharya indicated that no figures are available.

¶16. (U) During the January-August cease-fire (not the peak season), tourist arrivals increased by 15 percent to 172,394. Interestingly, the break in the cease-fire on 27 August has had apparently little impact in dampening tourist arrival numbers, according to Department of Immigration figures. Numbers reported in September 2003 are up 25 percent in comparison to September 2002 numbers, and October 2003 arrivals increased by over 41 percent in comparison the October 2002. However, while low-spending backpacker tourists are still coming, the higher-end older travelers definitely have decreased. While many of the hotels in Kathmandu are now filled, it is at a room charge a quarter of the past normal rates.

¶17. (U) The Maoists continue to indicate that they will not target tourists. However, foreign visitors regularly are faced with extortion and harassment when traveling outside the Kathmandu Valley. (Note: October and November are the peak trekking season in Nepal, and many of those traveling made plans prior to the break in the cease-fire. Rather than canceling and paying penalties, American travelers stopping by the Embassy's Consular Section have indicated that they are accepting the additional risks associated with trekking

in Nepal. End Note.)

Additional Factors

118. (U) Additional indices of the economic cost of the insurgency include:
-- Figures from the Private and Boarding Schools Organization of Nepal (PABSON) indicate that 2,300 schools outside the Kathmandu Valley closed during 2003 as a result of the insurgency. Consequently, over 425,000 students are now unable to attend school.

-- Faced with a decrease in domestic employment opportunities and possible forced conscription in the Maoist's "Peoples Army," the Department of Labor and Employment Promotion reports an increase of 28 percent during 2002/03 in Nepalese seeking work abroad. The country earns more than USD 1 billion annually in foreign remittances, which amounts to 18 percent of GDP.

-- The Economist Intelligence Unit's November 2003 Country Report estimates that the 18 - 20 September general strike cost the Nepalese economy about NRs. 3 billion (or USD 41 million). Media reports from the period reported that a majority of businesses and educational institutions were intimidated and adhering to the strike.

Comment: A Caveat

119. (U) It is a daunting task to assess the cost of the insurgency. GON and private industries, figures are sometimes over estimated or not tallied in a uniform manner. For example, although the GON could provide dollar figures for the destruction of infrastructure, we found data on how these figures were calculated either unavailable or not updated on a regular basis.

120. (U) Comment Continued. Nepal's economic future is bleak: low social indicators, poor basic infrastructure, inadequate means to get goods to the market, and general failure to diversify or focus on product marketing. These problems coupled with the increase in Maoist violence, create an uncertain future for the Nepalese economy. The evidence compiled from Post's research portrays a downward trend in the economy and for society as a whole. Continued security demands on the GON budget, coupled with a decrease in foreign investment and international assistance, bode poorly for Nepal's economic and development future. It is clear that Nepal's downward economic trend is gaining momentum. No single sector of the economy is in a position to bring it back into economic growth. Revenues from tourism have plummeted, and the next largest foreign exchange earner, the ready-made garment industry, is facing a precarious future when quotas are eliminated in December 2004 under the Multi-fibre Agreement. Without dramatic change, Nepal may be heading into a downward spiral of poverty, destruction, and stalled socio-economic development, fed by the insurgency. (Note: Graphs with further information have been e-mailed to the SA/INS Desk Officer. End Note.) End Comment.

MALINOWSKI